CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

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25. Social Security

> ***Congress should*** allow young workers to redirect their payroll taxes to individually owned, privately invested retirement accounts.

The debate over Social Security reform was poorly served by the 2002 congressional elections. With a declining stock market as a backdrop for dueling attack ads, too many candidates became embroiled in a pointless debate over the meaning of the word ‘‘privatization.’’ The public was left without a clear presentation of the problems facing Social Security or of the pros and cons of various solutions. But as campaigning gives way to governing, Congress must recognize that Social Security is facing serious problems and must be reformed.

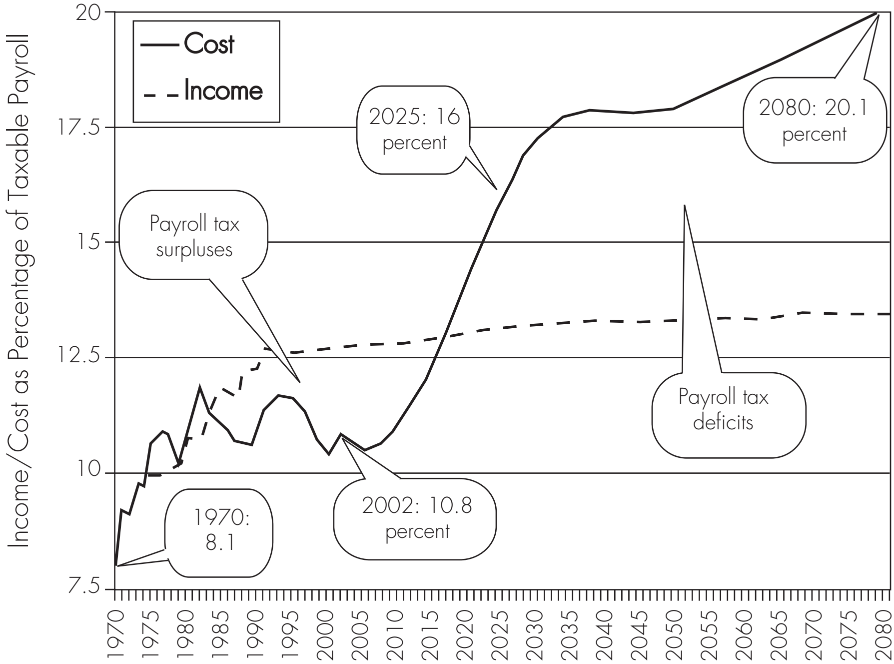
Why Reform Social Security?

There are five main reasons to reform Social Security.

Keeping Social Security Solvent

Social Security is going bankrupt. The federal government’s largest spending program, accounting for nearly 22 percent of all federal spending, faces irresistible demographic and fiscal pressures that threaten the future retirement security of today’s young workers. According to the 2001 report of the Social Security system’s Board of Trustees, in 2017, just 14 years from now, the Social Security system will begin to run a deficit (Figure 25.1) That is, it will begin to spend more on benefits than it brings in through taxes. Anyone who has ever run a business—or balanced a checkbook—understands that when you are spending more than you are bringing in, something has to give: you need to start either earning more money or spending less to keep things balanced. For Social Security, that means either higher taxes or lower benefits.

Figure 25.1
Social Security Cost and Income



In theory, Social Security is supposed to continue paying benefits after 2017 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide enough money to guarantee benefits until 2041, when it will be exhausted. But one of Washington's dirty little secrets is that there really is no trust fund. The government spent that money long ago to finance general government spending and hide the true size of the federal budget deficit. The trust fund now consists only of IOUs—promises that at some time in the future the government will replace that money, which can only be done by collecting more taxes or issuing even more debt.

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2041. At that point, Social Security will have to rely solely on revenue from the payroll tax. But that revenue will not be sufficient to pay all promised benefits.

There are limited options available. Former president Bill Clinton pointed out the choices: (a) raise taxes, (b) cut benefits, or (c) get a higher rate of return through investment in real capital assets. Henry Aaron of the Brookings Institution, a noted opponent of privatization, agrees. ''Increased funding to raise pension reserves is possible only with some combination of additional tax revenues, reduced benefits, or increased investment returns from investing in higher yielding assets,'' he told Congress in 1999.

The tax increases and benefit cuts would have to be large. To maintain benefits after the system starts running a deficit in 2017, the government must acquire new funds equivalent to $103 per worker. By 2030, the additional tax burden increases to $1,543 per worker, and it continues to rise thereafter. Functionally, that would mean an increase in payroll taxes of roughly 50 percent, or an equivalent increase in income or other taxes.

If both individual accounts and tax increases are off the table, then, *by law*, benefits will have to be cut. Current estimates suggest that benefits may have to be reduced by as much as a third. That would have a devastating effect on those Americans most dependent on Social Security for retirement income. Studies indicate that as many as 20 percent of American seniors receive nearly all their retirement income from Social Security.

It is important to realize that doing nothing is the same as endorsing benefit cuts. Since, by law, once Social Security no longer has enough revenue to pay benefits, without reform, benefit cuts are inevitable. In this case, not to act is to act.

A Better Deal for Young Workers

Even if Social Security did somehow manage to pay all its promised benefits, the taxes paid by today's young workers are already so high that promised benefits would be a bad deal in return for those taxes. Those benefits represent a low, below-market rate of return, or effective interest rate, on the taxes workers and their employers have to pay into the system throughout their careers (Table 25.1). Studies show that investing those tax funds instead in private savings and insurance would likely yield three or more times the benefits Social Security promises to today's young workers. In fact, retiring workers will receive returns from Social Security that are below those of risk-free government bonds.

Look at it another way: A single worker born in 1965, paying the maximum in Social Security taxes, and retiring in 2030 would have to live to over age 90 just to get back what he or she had paid into the system (Table 25.2). This means that entire generations will lose money under the current Social Security system.

Table 25.1
Real Rates of Return Falling for All Retirees (assumes no change in law, retirement at age 65)

Birth Year	Single Male (medium wages)	Single Female (medium wages)	Single-Earner Couple (medium wages)	Two-Earner Couple (medium/low wages)
1970	1.13	1.59	3.42	2.24
1980	0.91	1.36	3.31	2.08
1990	0.88	1.29	3.14	1.97
2000	0.86	1.25	3.02	1.88

SOURCE: Social Security Office of the Actuary calculations, May 27, 2001.

Table 25.2
What Age Must You Reach to Get Back What You've Paid In?

Year of Birth	Age an Average Earner Gets Back Taxes Paid into the Retirement Portion of Social Security	Total Life Expectancy for Individual Reaching Age 65	
		Male	Female
1875	65.2	77.7	79.7
1895	66.1	78.2	82.4
1915	67.8	79.7	83.9
1936	81.8	81.3	84.6
1945	85.2	81.9	85
1955	89.7	82.5	85.6
1965	91.9	83	86.1

SOURCE: Congressional Research Service, ''Social Security: The Relationship of Taxes and Benefits for Past, Present, and Future Retirees,'' June 22, 2001; updated via telephone conversation with author. Under the intermediate assumptions of the 2001 Trustees Report and taking into account benefit increases and continued accrual of interest after retirement but not the taxation of benefits. The retirees are assumed to begin work at age 22 and retire in January of the year in which they turn 65. Assumes contributions earn interest equal to the long-term government bond rate.

Moreover, this may understate the problem since it assumes that Social Security will continue to pay promised benefits without increased taxes. But, as we have seen above, that is impossible.

Savings and Economic Growth

Social Security operates on a pay-as-you-go basis; almost all of the funds coming in are immediately paid out to current beneficiaries. This system displaces private, fully funded alternatives under which the funds coming in would be saved and invested for the future benefits of today's workers. The result is a large net loss of national savings, which reduces capital investment, wages, national income, and economic growth. Moreover, by increasing the cost of hiring workers, the payroll tax substantially reduces wages, employment, and economic growth as well.

Shifting to a system of individual accounts, with hundreds of billions of dollars invested in private capital markets, could produce a large net increase in national savings, depending on how the government financed the transition. This would increase investment, productivity, wages, and jobs. Replacing the payroll tax with private retirement contributions would also improve economic growth, because the required contributions would be lower and those contributions would be seen as part of a worker's direct compensation, stimulating more employment and output.

Helping the Poor

Low-income workers would be among the biggest winners under a private system. The higher returns and benefits of a system that relies on private investment would be most important to low-income families, as they most need the extra funds. The funds saved in the individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from reforming Social Security would be most important to the poor. Moreover, if we continue on our current course, low-income workers will be hurt the most by the higher taxes or reduced benefits that will be necessary. Averting a financial crisis and its inevitable results would consequently be most important to low-income workers.

In addition, with average- and low-wage workers accumulating large sums in their own investment accounts, the distribution of wealth throughout society would become far broader than it is today. That would occur, not through the redistribution of existing wealth, but through the creation of new wealth, far more equally held. Because Social Security investment accounts would make every worker a stockowner, the old, senseless division between labor and capital would be eroded. Every laborer would become a capitalist. The socialist dream of the nation's workers owning its businesses and industries would be effectively achieved. At the same time, as the nation's workers became capitalists, support for free-market, pro-growth economic policies would increase in all sectors of society.

That social effect is one of the least cited but most important reasons for giving workers more control over their retirement savings.

Ownership and Control

After all the economic analysis, however, perhaps the single most important reason for privatizing Social Security is that it would give American workers true ownership of and control over their retirement benefits.

Many Americans believe that Social Security is an earned right. That is, because they have paid Social Security taxes they are entitled to receive Social Security benefits. The government encourages this belief by referring to Social Security taxes as ''contributions,'' as in the Federal Insurance Contributions Act. However, the U.S. Supreme Court has ruled, in *Flemming v. Nestor,* that workers have no legally binding contractual or property right to their Social Security benefits, and those benefits can be changed, cut, or even taken away at any time.

As the Court stated, ''To engraft upon Social Security a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands.'' That decision built on a previous case, *Helvering v. Davis,* in which the Court had ruled that Social Security is not a contributory insurance program, stating that ''the proceeds of both the employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way.''

In effect, Social Security turns older Americans into supplicants, dependent on the political process for their retirement benefits. If they work hard, play by the rules, and pay Social Security taxes their entire lives, they earn the privilege of going hat in hand to the government and hoping that politicians decide to give them some money for retirement.

In contrast, under a system of individual accounts, workers would have full property rights in their private accounts. They would own their accounts and the money in them the same way they own their individual retirement accounts (IRAs) or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

The President's Commission

In May 2001, President Bush appointed former senator Daniel Patrick Moynihan and AOL/Time Warner executive Richard Parsons to co-chair the President's Commission to Strengthen Social Security. The 16-member bipartisan commission was charged with devising Social Security reform proposals according to the following principles: modernization must not change Social Security benefits for retirees or near retirees; the entire Social Security surplus must be dedicated to Social Security only; Social Security payroll taxes must not be increased; the government must not invest Social Security funds in the stock market; modernization must preserve Social Security's disability and survivors' components; and modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.

Three members of the commission, Lea Abdnor, Sam Beard, and former representative Tim Penny (D-Minn.), have worked with Cato's Project on Social Security Choice. Cato Social Security analyst Andrew Biggs served as a staff member to the commission.

In August 2001 the commission released its interim report, which outlined the demographic pressures on the current pay-as-you-go program and argued that the current trust fund financing mechanism did not effectively save today's payroll tax surpluses to fund future benefit obligations. Over the remainder of the year, the commission held a number of public hearings and meetings, which often became the target of protests from opponents of personal retirement accounts.

Nevertheless, in December the commission delivered its recommendations to the president. Those included three proposals illustrating how personal retirement accounts could be integrated into the current Social Security program, strengthening the system for the future while giving workers ownership of and control over at least a part of their payroll taxes.

The commission's Plan 1 did nothing other than add voluntary personal accounts to Social Security. Workers could choose to invest 2 percent of their wages in a personal account. In return, workers with accounts would give up a portion of their traditional retirement benefits. While Plan 1 did not bring the system back to solvency, it illustrated that individual accounts could increase benefits for all retirees while improving the financing health of the program.

The commission's Plan 2 allowed workers to divert 4 percentage points of their payroll taxes to a personal account, up to an annual maximum of $1,000 (which would be indexed annually to the growth of wages). To bring the traditional program back to financial balance, Plan 2 would increase the initial benefits each cohort of new retirees receives by the rate of price growth, rather than wage growth as under current law. This ''price indexing'' of initial benefits would bring the program back to solvency and eventually deliver substantial payroll tax surpluses. In addition, Plan 2 contained new protections for low-wage workers and lower-income widows. Plan 2 would be substantially cheaper than the current system, requiring general revenue transfers 68 percent smaller (measured in today's dollars).

The commission's Plan 3 would allow workers to divert 2.5 percentage points of their payroll taxes to a personal account (up to an annual maximum of $1,000), provided they voluntarily deposited an additional 1 percent of their wages in the account. Plan 3 would pay all retirees a larger benefit than that promised by the current program—and at a substantially lower cost over the long term. Measured in today's dollars, the general revenue cost of Plan 3 was less than half that of maintaining the current program. Like Plan 2, Plan 3 contained new protections for low-wage retirees and lower-income widows.

Together, the three commission plans show that personal accounts enable a reformed Social Security program to pay higher benefits at lower cost than the current pay-as-you-go method of financing.

Principles for Reform

As it approaches the historic debate over Social Security reform, Congress should keep in mind five basic principles.

Solvency Is Not Enough

Workers deserve the best possible deal for their dollar. With Social Security facing a financial crisis—it will begin running a deficit in just 14 years—much attention has been focused on ways to keep the program solvent. Theoretically, that could be accomplished by raising taxes or cutting benefits. But Social Security faces a second crisis as well: Young workers will receive a negative rate of return from the program. They will get less back in benefits than they pay in taxes. That low return, and other inequities, particularly disadvantages women, the poor, and minorities. Any Social Security reform must reverse this trend, raising the rate of return and providing higher retirement benefits.

Individuals, Not Government, Should Invest

The only way to increase Social Security's rate of return is to invest Social Security taxes in real capital assets. This should be done through the creation of individually owned accounts, not by allowing the government to directly invest payroll taxes. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth on to their heirs; it would also give them a greater stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company, posing a potential threat to corporate governance and the specter of social investing.

Maximize Consumer Choice

Workers should be given as wide a range of investment opportunities as possible, consistent with regulatory safeguards against fraud or speculation. While investing in ''Singapore derivatives'' is clearly not envisioned, there is no reason to limit workers to only two or three index funds. As much as possible, the existing retirement savings infrastructure should be used, meaning workers would have a large number of safe and secure options. Moreover, a safety net would guarantee that no senior would end up in poverty as a result of bad investments.

Don't Touch Grandma's Check

Benefits to the currently retired and nearly retired should not be reduced. Indeed, by explicitly recognizing benefits owed to current retirees, Social Security reform would guarantee those benefits in a way that the current political system does not. Making the transition to a new system while guaranteeing current benefits means that the government will have to issue debt, cut current spending, or sell assets, but those ''transition costs'' will be substantially less than the costs of maintaining the current system.

More Investment Is Better Than Less

You don't cut out half a cancer. Given the advantages of individual accounts, there is no excuse for stopping at only 2–3 percent of payroll taxes. Once Congress has conceded that private capital investment can provide better and more secure retirement benefits, it should press on and allow workers to control the maximum feasible amount of their retirement income.

Answering the Objections

The Transition

The most difficult issue associated with any proposed reform of Social Security is the transition. Put quite simply, regardless of what system we choose for the future, we have a moral obligation to continue benefits to today's recipients. But if current workers divert their payroll taxes to individual accounts, those taxes will no longer be available to pay benefits. The government will have to find a new source of funds.

However, it should be understood that this is not a new cost. It is really just making explicit an already existing unfunded obligation. The federal government already cannot fund as much as $25 trillion of Social Security's promised benefits. Reforming Social Security, therefore, will actually reduce the amount of debt we owe.

The tradeoffs in refinancing a home mortgage provide a useful analogy. There are costs associated with achieving a lower interest rate, such as points, title insurance, a title search, attorneys' fees, a credit report, and the like. The decision to refinance is based not only on the lower interest rate but on those costs as well. If the present value of the costs and the lower interest expense is less than the present value of the existing mortgage interest expense, then there is a net benefit from refinancing even though costs are incurred to achieve it. With Social Security, the cost of paying for the transition to a system of individual accounts will be less than the cost of preserving the current system.

Of course there will be a temporary cash flow problem while we make the transition. We will have to find the revenues to pay benefits to current retirees. Any financing mechanism will be political, involving some combination of debt, transfers from general revenues, asset sales, and the like. If both parties are willing to forgo new spending programs and junk tax cuts, we can begin the transition to a new, improved Social Security system.

There are several methods of financing the transition. For example, a small portion of the payroll tax could be continued temporarily. Workers could be allowed to invest their half of the payroll tax (6.2 percentage points of 12.4 percent) with the remainder temporarily being used to fund a portion of continued benefits. Congress could also identify additional spending cuts and use the funds saved to finance the transition. Because much federal government spending is wasteful or counterproductive, such cuts would not be any sacrifice for society—indeed, the cuts themselves might provide many benefits. A list of potential cuts can be found in Chapter 23. The government could also sell many assets that it currently owns. Finally, the government could issue bonds to spread the cost of transition over several generations. It is important to understand that this is not new debt; it is simply the explicit recognition of an existing implicit debt under the current system.

Risk

Last year's turmoil in the stock market provided ample evidence that in any given year stocks can go down as well as up. But, in truth, the year-to-year fluctuations of the stock market are irrelevant. What really counts is the long-term trend of the market over a person's entire working lifetime, in most cases 40 or 45 years. Given that long-term perspective, there is no period during which the average investor would have lost money by investing in the U.S. stock market. In fact, during the worst 20-year period in U.S. history, which included the Great Depression, the stock market produced a positive real return of more than 3 percent.

As Figure 25.2 shows, even with the recent stock market decline, a worker investing only in stocks would receive benefits 2.8 times higher than he would had he ''invested'' the same amount of money in the current program.

Put another way, the recent decline in stock prices means the worker's personal account would be worth the same today as it was worth in 1997. But that worker's Social Security ''savings'' would be worth today only what the personal account was worth in the late *1980s*. It would take a

Figure 25.2
Value of Personal Accounts and Social Security Benefits

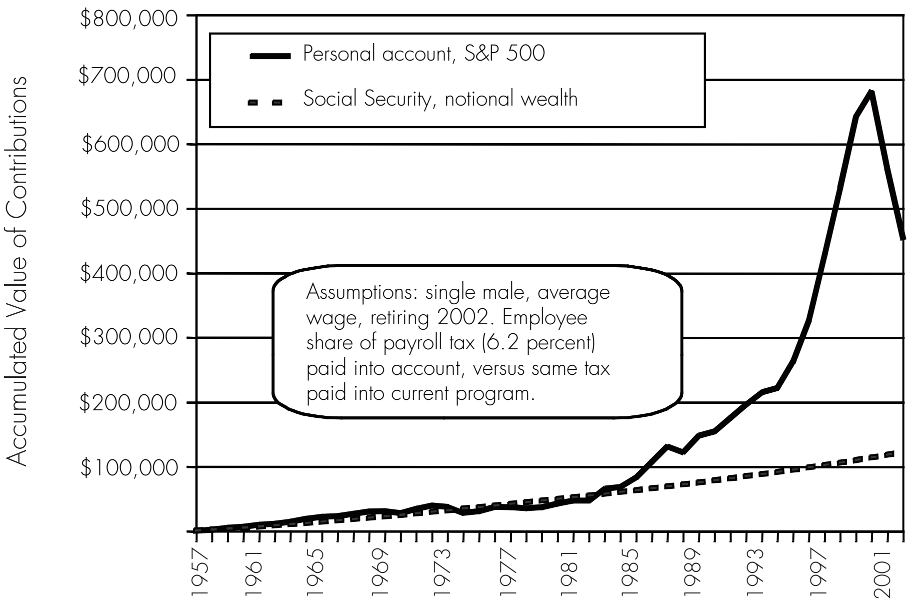
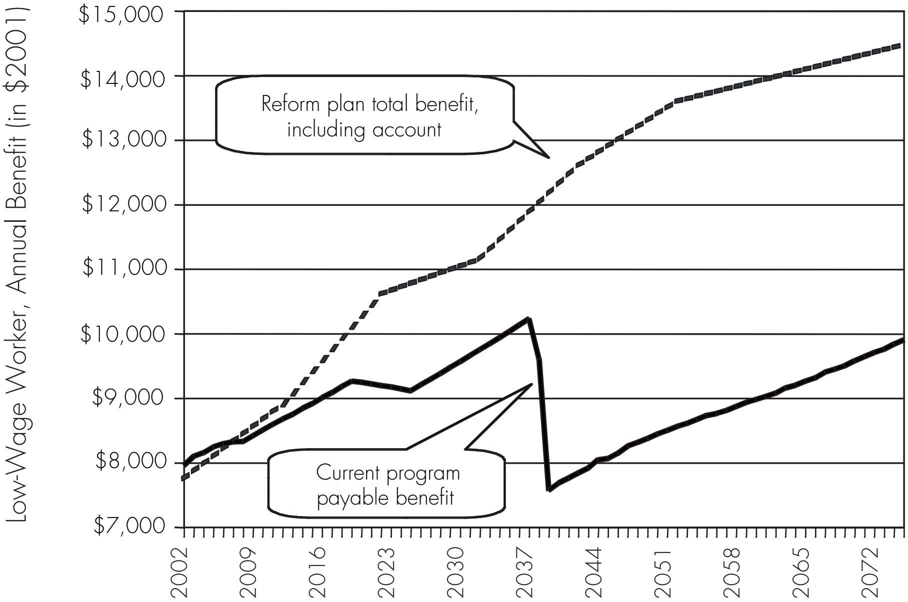


Figure 25.3
Total Benefits



much larger decline than the one we have seen for a personal account to be a worse deal than the current program.

Benefit Cuts

Many opponents of individual accounts charge that creating such accounts would lead to benefit cuts. However, that claim is based on two faulty premises. First, opponents compare privatization proposals with current law and suggest that those proposals will provide lower benefits, or at least lower government-provided benefits. Second, they suggest that transition costs to a privatized system will require tax increases.

But as Charles Blahous, executive director of the President's Commission to Strengthen Social Security, has pointed out, ''The essential problem with comparing reform plans with 'current law' is that 'current law' allows the system to go bankrupt.'' Or, as David Walker, comptroller of the United States, warned: ''There's a lot of people that want to compare Social Security reform proposals to promised benefits. That is fundamentally flawed and unfair because all of funded benefits are not funded.'' A fair test of Social Security reform proposals, including those that include

Experts Speak Out on the Trust Fund

Congressional Budget Office: ''The size of the balance in the Social Security Trust Funds—be it $2 trillion, $10 trillion, or zero—does not affect the obligations that the federal government has to the program's beneficiaries. Nor does it affect the government's ability to pay those benefits.''

General Accounting Office: Social Security's ''Trust Funds are not like private Trust Funds. They are simply budget accounts used to record receipts and expenditures earmarked for specific purposes. A private Trust Fund can set aside money for the future by increasing its assets. However, under current law, when the Trust Funds' receipts exceed costs, they are invested in Treasury securities and used to meet current cash needs of the government. These securities are an asset to the Trust Fund, but they are a claim on the Treasury. Any increase in assets to the Trust Funds is an equal increase in claims on the Treasury.''

Congressional Research Service: ''What often confuses people [about the Trust Funds] is that they see these securities as assets for the government. When an individual buys a government bond, he or she has established a financial claim against the government. When the government issues a security to one of its own accounts, it hasn't purchased anything or established a claim against some other person or entity. It is simply creating an IOU from one of its accounts to another.''

Clinton Administration 2000 Budget: ''[Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. . . . They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the government's ability to pay benefits.''

individual accounts, is to compare them, not to promised benefits, but to benefits that can actually be paid. By that standard, proposals to create individual accounts come out far ahead.

Moreover, opponents of individual accounts frequently omit the funds accumulating in those accounts when making comparisons. They compare only government-provided benefits with government-provided benefits. But that omits half the story. When *total* benefits under individual account plans, that is benefits from the accounts plus government-provided benefits, are considered, these plans provide benefits in excess of what Social Security has promised, let alone what it can pay (Figure 25.3).

Conclusion

The American people have shown themselves ready for fundamental Social Security reform. Now is the time for Congress to act. There is little that the 108th Congress could do that would have a more profound impact on the lives of the American people.

Suggested Readings

Biggs, Andrew. ''Personal Accounts in a Down Market: How Recent Stock Market Declines Affect the Social Security Reform Debate.'' Cato Institute Briefing Paper no. 74, September 10, 2002.

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______. *Common Cents, Common Dreams: A Layman's Guide to Social Security Privatization*. Washington: Cato Institute, 1998.

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Rounds, Charles. ''Property Rights: The Hidden Issue of Social Security Reform.'' Cato Institute Social Security Paper no. 19, April 19, 2000.

Tanner, Michael. ''No Second Best: The Unappetizing Alternatives to Individual Accounts.'' Cato Institute Social Security Paper no. 24, January 29, 2002.

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